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NO. 597

In the Supreme Court of the United States

October Term, 1925

AMERICAN NATIONAL COMPANY, as Receiver for
The F. B. Collins Investment Company,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal From the District Court of the United States
for the Western District of Oklahoma

BRIEF OF APPELLANT

(b)

There was no opinion delivered in this case by the court below, and consequently there is no official report thereof to which reference can be made.

(c)

(1) The date of the judgment to be reviewed is

March 30, 1925 (R. 12-13). This judgment is based upon a stipulated statement of facts (R. 8-12), which was adopted by the court in its judgment as its findings of fact in the case (R. 13).

(2) The specific claim advanced by the appellant in the lower court is that the case arises under the Revenue Act of 1916 and the Revenue Act of 1917, and is based upon the alleged fact that income and war excess profits taxes for the year 1917, in the sum of $4,287.64, were wrongfully, erroneously and illegally assessed against and collected from the F. B. Collins Investment Company by the Commissioner of Internal Revenue, and that the said F. B. Collins Investment Company paid the same under protest, and thereafter filed its claim for refund thereof with the Commissioner of Internal Revenue, which claim was by the Commissioner rejected prior to the commencement of the suit (R. 2-3). The appellant's claim is, therefore, one against the United States founded upon a law of Congress, and this fact is relied upon as the basis of this court's jurisdiction. The lower court overruled and denied the appellant's contention that said taxes were wrongfully, erroneously and illegally assessed and collected and gave judgment against it for costs (R. 13). The appellant claims that this judgment is not supported by the findings of fact on which it is based and is contrary to law.

(3) The statutory provisions under which the jurisdiction of this Court is invoked are the judicial code of March 3, 1911, chap. 231, Sec. 24, par. 20, 36 Stat. at L. 1087, 1093, formerly the Tucker Act of March 3, 1887, chap. 359, Secs. 1, 2, 24 Stat. at L. 505, as these provisions were before the amendment of 1925.

(4) The following cases are believed to sustain the jurisdiction.

—*United States* v. *Emery, Bird, Thayer Realty Co.*, 237 U. S. 28, 35 Sup. Ct. 499, 59 L. ed. 825, and cases therein cited.

J. Homer Fritch, Inc., et al. v. *United States*, 248 U. S. 458, 39 Sup. Ct. 158, 63 L. Ed. 359, and cases therein cited.

(d)

This action was begun by the appellant by the filing of its petition on February 28, 1924 (R. 1). The following facts are alleged in the petition and admitted in the defendant's answer.

The appellant and The F. B. Collins Investment Company, for which it is receiver, are both corporations organized and existing under the laws of the State of Oklahoma, and having their places of residence and principal offices at Oklahoma City, in the Western Judicial District of the State of Oklahoma (R. 1). In May, 1923, in an action in a state court of the State of Oklahoma, designated as the District Court of Oklahoma County, in

the State of Oklahoma, the appellant was appointed receiver for The F. B. Collins Investment Company and duly qualified under such appointment, and has been ever since the 15th day of May, 1923, and still is, the duly appointed, qualified and acting receiver for the said company (R. 1-2, 7).

Prior to the 30th day of December, 1922, the Commissioner of Internal Revenue assessed additional income and war excess profits taxes against The F. B. Collins Investment Company for the year 1917. On December 30, 1922, and after written notice and demand from the Collector of Internal Revenue for the District of Oklahoma, said company paid the said taxes under protest (R. 2, 7). Of the amount so paid, The F. B. Collins Investment Company, and the appellant as its receiver, claimed that the principal sum of $4,287.64 was unlawfully, illegally and erroneously assessed and collected, together with the sum of $463.12 interest thereon (R. 3). Of the above principal sum of $4,287.64, $19.28 was paid by the credit of that amount from an over-payment by the taxpayer for the year 1919 (R. 3, 7). Immediately upon the payment of the above tax and interest, the taxpayer filed a claim for the refund of the amount stated of principal and interest with the Commissioner of Internal Revenue, and on August 1, 1923, such claim for refund was by the Commissioner rejected (R. 3, 8).

The foregoing covers the facts admitted upon the pleadings. The sole controversy in the case was over the legal effect of the taxpayer's method of keeping its accounts and reporting its income, or more specifically as to whether certain items of expense in the conduct of its business were to be deducted from income in the year in which incurred or in the year in which paid. There was no dispute as to the facts in this regard, so that the question became purely one of law. Prior to the trial the parties stipulated and agreed upon the essential facts involved. This stipulation was adopted *in toto* by the court as its findings of fact in the case, and, therefore, it presents all the facts, in addition to those alleged in the petition and admitted in the answer, upon which the judgment of the court is based. The findings of fact thus made are as follows, certain important portions of which we have italicized:

"The F. B. Collins Investment Company, the taxpayer involved in this action, and hereinafter referred to as the company, was at all times mentioned herein a corporation, duly organized and existing under the laws of the State of Oklahoma, with its principal office and place of business at Oklahoma City, in said State. Its business was that of negotiating and making loans secured by mortgages upon farm and city real estate, and the sale of such loans to investors. It had been engaged in such business since its incorporation in March, 1908. For making the loans, it received commissions, usually in the form of non-interest bearing notes, from the borrowers. The amount of the commission on a given loan was fixed at a certain per cent per annum, usually two

per cent, of the amount of the loan for its term. The company's income was derived from these commissions.

"Beginning about the year 1916, the company was able, by reason of having established its business and made a reputation for handling safe and desirable loans, to sell many of its loans direct to investors without the aid or assistance of a broker or agent in so doing, though it still sold some of them through brokers or agents.

"As an inducement to investors to purchase such loans direct, the company agreed to pay a bonus to the investor upon the sale of such loan, this being an added consideration to the investor for the purchase of such loan and being made possible by the fact that the company was relieved from paying any brokerage fee or agent's commission upon such sale. This bonus or added consideration to the investor was uniformly put in the form of a contract of the company by which it became obligated and bound to (R. 8) pay to such investor one per cent of the principal of the loan annually during the life thereof.

"The nature of the company's business and the method by which each transaction was handled can best be set forth by an illustration or example of a particular loan, and for this purpose the following is submitted.

"A borrower made application to the company for a five-year farm mortgage loan for the sum of $10,000.00 and executed his principal note or bond to the company bearing interest at the rate of five per cent per annum payable annually. At the same time the borrower also executed another note for the sum of $1,000.00, which was non-interest bearing until maturity and which was usually due in two years from date, and which represented the company's commission or compensation for its services in making and negotiating the loan. The principal note was secured by a first mortgage on real estate and the commission note was usually secured by a second mortgage upon the same real estate.

"In order for the company to sell the $10,000.00 principal note direct to a permanent investor, and as an inducement to such investor to purchase the same, it agreed and obligated itself to pay such investor an amount equal to one per cent per annum on the principal of the note, payable annually, for the full term thereof, or until payment, if paid before maturity.

"The company's obligation to pay the investor this one per cent per annum of the principal of the note was evidenced by a written contract, a copy of which is attached hereto, marked 'Exhibit A' and made a part hereof. At the time the note was sold to the investor, *the company charged on its books, as an expense incurred in the sale of the loan, the full amount of the annual payments provided for in the bonus contract referred to above, which it had given to the investor, computed at one per cent per annum on the face of the loan from the date of the contract to the maturity of the loan, and credited the investor on its books with a like amount.*

"The credits to investor's accounts by reason of these bonus contracts, given in the selling of loans, were handled on a subsidiary bills' payable ledger; and the total amount of this liability of the company as shown by the ledger was carried on the general ledger under a control account called the Guaranty Fund Account.

"The form of bond or note taken by the company in making its loans to borrowers, a copy of which is attached as 'Exhibit B' hereto, provided for the payment of $100.00 or any multiple thereof, or the whole amount of the loan, at any interest paying date after two or three years, at the option of the borrower, by giving sixty days' notice. In a very few instances the privilege of paying the note before maturity has been allowed to the borrower at the end of one year, but this was rarely done, the time usually fixed being at or after two years, although quite frequently it was fixed at three years or after. *In the event that the principal loan or note was paid before maturity, the difference between the amount*

of the bonus contract credited to the investor's account at the time the loan was sold to him and the actual payments made on such bonus (R. 9) *contract by the company was credited back to profit and loss, and treated as income of the company for the year in which the payment of the principal loan occurred.*

"*The company consistently kept its books of account from year to year on an accrual basis.* For the year 1917 it accrued and set up on its books as a liability and charged to expense, the total amount of the annual payments provided for in bonus contracts executed and issued to investors during said year, the amount of each contract being taken at one per cent per annum, of the amount of the loan to which it related, from the date of the contract to the maturity date of the loan. This practice had been followed from the inception of the company's so-called bonus method of selling its securities to permanent investors. *Its tax return for the year 1917 was made upon the basis upon which its accounts were kept.*

"The tax in dispute in this action was assessed and paid for the year 1917. The Commissioner fixed and determined the company's net income for that year at $40,746.26. Upon this net income he computed and determined the company's tax to be $10,456.36. This amount of tax was assessed against the company and duly paid. It is admitted and agreed by the plaintiff as receiver for the company that $6,168.72 of such tax was correctly and legally assessed and collected.

"During the year 1917 the company executed its bonus contracts to purchasers of its mortgage loans in the aggregate amount of $11,082.90. In arriving at this aggregate sum the amount or value of each bonus contract was fixed and taken at one per cent per annum of the amount of the loan to which it related, computed from the date of the contract to the maturity of the loan. The company claimed this sum of $11,082.90 was an expense incurred and accrued in its business and as such was de-

ductible from income. The Commissioner disallowed the deduction of this sum, but allowed as a deduction from gross income as an expense on this account only the amount representing the company's obligations under its agreements with investors which matured within the year 1917 and which amount was the sum of $1,677.11. The difference between the sum of $11,082.90 as claimed by the company, and the sum of $1,677.11, as allowed by the Commissioner, to-wit, the sum of $9,405.79, was the net disallowance [as a deduction] from gross income on account of contracts with investors.

"The right of the company to this deduction from income is the question in dispute in this action. The tax involved is attributed solely to this item. If it was not deductible, then the company's income was correctly fixed by the Commissioner at $40,746.26, and the full amount of tax paid was properly and legally assessed and collected, and the plaintiff is not entitled to any recovery in this action. If it was deductible, then the company's net income was only $31,340.47, and the tax here in controversy in the sum of $4,287.64 was erroneously assessed and collected, and the plaintiff is entitled to recover a judgment for said sum plus $463.12 interest paid thereon, or a total sum of $4,750.76, with interest on such total sum at the rate of six per cent per annum from December 30, 1922 (R. 10), being the date of payment of such sum. This payment was made under protest and after notice and demand therefor by the Collector at Oklahoma City, Oklahoma" (R. 11).

The form of bonus contract, a copy of which was attached as "Exhibit A" to the foregoing statement and finding of facts, is as follows:

"Exhibit A to Statement of Facts.

"Special Guarantee. Loan No. 2000.

"Whereas, the F. B. Collins Investment Company (a corporation) is the mortgagee in a certain mortgage for Thousand and no/100 Dollars, executed by (*John Doe and Mary Doe, his wife*) dated the 30th day of June, 1918, covering certain immovable property situate in Lincoln County, State of Oklahoma.

"Whereas, said loan has been sold to (*Eastern Investor*) and in consideration of the purchase thereof, the said The F. B. Collins Company hereby agrees to pay the said purchaser one per cent per annum in addition to the five per cent the loan bears. The said one per cent to be paid during the life of said loan, according to the terms contained in the bond.

"Dated at Oklahoma City, Oklahoma, this 1st day of July, 1918.

"The F. B. Collins Investment Company,
"By (Signed)....., Vice President.
"Attest: (Signed)....., Secretary.

"(Written across face): Specimen Copy" (R. 11).

A copy of the form of mortgage note or bond used by The F. B. Collins Investment Company in negotiating its loans was attached as "Exhibit B" to the foregoing statement or finding of facts. It is the ordinary form of promissory note, with the following provision inserted, which is the only part material here:

"Privilege to pay $100.00 or any multiple thereof, or the whole amount, at the maturity of any interest payment, on and after two years, by giving sixty days' notice" (R. 12).

Upon the foregoing facts, the trial court held as a matter of law that the plaintiff was not entitled to any recovery from the defendant on account of income and profits taxes alleged to have been erroneously assessed and collected for the year 1917, and rendered judgment accordingly against the plaintiff for costs (R. 13). To this judgment the plaintiff at the time duly excepted and its exception was allowed (R. 13).

(e)

For its specification of errors, the appellant says that the said judgment of the lower court is not supported by the findings of fact upon which it is based, and is contrary to the law, in that it denies to the taxpayer the right to make return of its income to the Commissioner of Internal Revenue for taxation for the year 1917 upon the same basis upon which its accounts were kept, which basis clearly reflected its income, and further denies to the taxpayer the right to deduct from its gross income, for the purpose of determining its net taxable income, the items of expense in the form of its bonus contracts issued in that year to purchasers of real estate mortgage notes from it, as business expense incurred in such year and accrued upon its books of account.

(f)

For convenience, The F. B. Collins Investment Com-

pany will hereafter be referred to as the taxpayer or the company.

The argument for the appellant is directed to the establishment of the following propositions:

1. That the obligations of the company evidenced by its bonus contracts were an ordinary business expense.
2. That each contract was an item of expense incurred in the year in which such contract was issued.
3. That since the company kept its books and made its return for taxation on an accrual basis, the total of the bonus contracts issued during the year at their full face value or amount was deductible from gross income.
4. That the foregoing method of keeping its books and making its return correctly reflected the company's income.
5. That the bonus contracts were not for the payment of interest, nor were they contingent obligations, nor indefinite or for an unascertainable amount.
6. That the company's method of restoring the unpaid portion of a cancelled bonus contract to income in the year of its cancellation is the correct one for handling such a transaction upon its books so that they will at all times truly disclose its income and its financial condition.

Before entering upon the consideration of these propositions, reference should be made to the governing statutes. To state the whole case briefly, we may say that the correctness of the determination of the addi-

tional tax assessed by the Commissioner, and adjudged by the trial court to have been properly assessed, depends upon the construction of the Revenue Act of 1916 and its application to the particular method employed by the taxpayer in keeping its books of account and in making return for income and war excess profits taxes for the calendar year 1917. The amendments to the Revenue Act of 1916 made by the Revenue Act of 1917, in no manner affect the question involved in this case. The Revenue Act of 1917 imposed additional taxes to those imposed by the Revenue Act of 1916, but insofar as the determination of the taxpayer's net income is concerned, that is to be done entirely under the provisions of the Revenue Act of 1916 as a basis for the imposition and computation of the taxes prescribed by both acts. The pertinent provisions of the two acts are Secs. 10 (a), 12 (a), 13 (a) and 13 (d) of the Revenue Act of 1916, and Secs. 4 and 201 of the Revenue Act of 1917. Sec. 10 (a) of the Revenue Act of 1916 and Secs. 4 and 201 of the Revenue Act of 1917 relate solely to rates of taxation and no question involving their application is presented in this case, for it turns upon the single question of the ascertainment of the taxpayer's true net income. The tax imposed by these sections is upon the net income ascertained in accordance with the provisions of Secs. 12 (a), 13 (a) and 13 (d) of the Revenue Act of 1916. Sec 12 (a) reads in its essential part as follows:

"In the case of a corporation, joint stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources.

"First: All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity."

Sec. 13 (a) provides as follows:

"The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December 31."

Sec. 13 (d) is as follows:

"A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned."

First Proposition

The six propositions mentioned above will be considered in their order. They necessarily overlap more or less, and the argument upon them will doubtless do the same. They are given more as a convenience in ar-

rangement of the matter presented than as a comprehensive statement of the scope of the argument.

The appellant contends that the bonus contracts given in connection with the sale of the taxpayer's mortgage loans were ordinary and necessary expenses incurred within the year in the maintenance and operation of its business and property. It kept its accounts upon an accrual basis. All earnings and gains for the year were entered on its books as income, whether actually received during the year or not. The notes received by it as commission for its services in negotiating loans were included in income in the year received, although not paid nor payable until a later year. All expenses incurred in connection with the operation of its business were set up on its books as a liability and deducted from gross income in the determination of its net income, even though such expenses were not paid nor payable until a later year. As stated in the findings of fact, its return for the year 1917 was made upon the same basis upon which its books were kept. Following this method of bookkeeping, the bonus contracts which it gave to purchasers of its mortgage loans were treated as expense incurred in the sale of such loans and the amount thereof issued in any year was set up on its books as a liability in that year. The appellant contends that this was the only true and correct way to handle these items, so long

as its books of account were kept on an accrual basis. The Commissioner contended that these bonus contracts could not be accrued as expense, and were not deductible from income, in the year in which issued, but were deductible as expense only in the amount actually paid and in the year in which paid.

As set forth in the findings of fact, the company originally sold its loans to permanent investors through brokers or agents and always continued to sell some of them in that manner. For the services of the broker or agent in selling its loans, it paid a brokerage fee or commission in cash upon each sale when completed. It can hardly be necessary to argue that this brokerage fee or commission is an ordinary and necessary expense incurred during the year in carrying on business. It is of the same nature as salaries and wages paid for the services of employes in the carrying on of any business. The company's business was to make and sell loans. Its income consisted of the commissions received from borrowers for its services in negotiating loans. When one loan was sold, the money from it was used to make another. If no loans were sold, the company's only business would have been to loan its own money, and its only income would have been the interest on its money loaned, which would have left it without any taxable income of any consequence. The rapidity of the turnover of its

capital in selling its loans and reloaning the money measured the volume of its business and the size of its income. Hence the expense incurred in selling its loans was an ordinary and necessary one in carrying on its business, if it was to have any business, and was a large item of the expense incurred in and incident to the production of current income.

After conducting its business a few years, the company found that it could sell many of its loans direct to permanent investors without the intervention of a broker or agent. This would eliminate brokerage fees or commissions. But in order to facilitate and speed up such sales, the company found it necessary or desirable to give the investor some consideration for the purchase of a loan in addition to the interest such loan would yield. This it could afford to do, because it was saving the usual brokerage fee or commission. And this it could do in one of two ways, either (1) by discounting its loans and selling them at less than par, or (2) by paying the investor a bonus in some form upon his purchase.

For obvious reasons, the company did not want to sell the loans it had negotiated at a discount. They were all high class, well secured real estate mortgage loans. It had built up a reputation for them as safe and desirable investments by years of painstaking care and effort. This reputation would doubtless be impaired by

any offering of them for sale at less than their face value. It may be said that there is more of sentiment than substance in an objection to discounting the loans, but we think it a matter of common knowledge that sentiment, and reputation, which is powerfully affected by sentiment, have much to do, or may have much to do, with the market value and the public demand for almost any financial security. In any event, the company chose not to discount its loans.

But if it had discounted them, no one would contend for a moment that such discount was not deductible from its income as an ordinary and necessary expense incurred and paid during the taxable year in carrying on its business. Such discount would come within exactly the same classification as a brokerage fee or commission upon loans sold through a broker or agent. And all brokerage fees or commissions paid in cash were allowed by the Commissioner without question as expense deductions from current income.

The company chose to pay its investors a bonus or premium on each loan purchased as an inducement or added consideration for the purchase. This bonus or premium could be paid either in cash or by a note or contract to pay in the future. The company chose to pay it by a contract rather than in cash. If it had been paid in cash, no one, we presume, would contend that it

was not an expense of the company in selling loans and as such deductible from its gross income in the year *in which it was incurred and paid.* But the only difference between the payment of the bonus in cash and the payment of it by a note or contract is that *in the first instance the expense is incurred and paid, and in the second instance it is incurred and accrued, in the year in which the sale is had.* Where books are kept on an accrual basis, expenses incurred and accrued within the year must be deducted from the gross income for that year, if they are to be deducted at all.

It is plain, indeed, that the Commissioner's contention is not that payment in the shape of a bonus to a purchaser of the company's mortgages is not a deductible expense, for that fact is conceded by his action in deducting such items when and in the year in which actually paid. This action by the Commissioner is shown in the statement and finding of facts. Therefore, both the taxpayer and the Commissioner are agreed that bonuses paid to induce the sale of the mortgage loans are a deductible expense, but in respect to them the Commissioner would put the taxpayer on a cash receipts and disbursements basis, and would allow them to be deducted only as actually paid, while the taxpayer contends that since its books were kept upon an accrual basis and items of gain were accrued and included in income when

earned, although not received until a later year, it must, in order for its income to be correctly ascertained and determined, deduct expense incurred in the production of such income in the year in which incurred, although not actually paid until a later year.

Second Proposition

The fact that the liability evidenced by each bonus contract, whether expense or not, was incurred in the year in which the contract was issued, would seem too clear for argument. It was incurred by the company in selling a mortgage loan. To repeat, the company's business consisted of making loans, for which it received a commission, then selling them and again loaning the money and receiving another commission, and so on in this manner. When a loan was made, the commission, either in cash or generally in notes, was included in income on the company's books at the time the loan was closed and the cash or notes received. Upon selling a loan the company executed and delivered to the purchaser its written contract that it would pay him one per cent of the face of the loan, in addition to the rate of interest it bore, until its maturity. Whatever this contractual obligation of the company was, it was certainly *incurred at the time such contract was executed and delivered.* When the contract was signed and delivered, the obligation was then complete and binding. There-

fore, if it constituted expense at all, it was incurred and was deductible from gross income in the year in which issued.

To illustrate by an example, suppose the company loaned a farmer $10,000.00, for which he gave his note, payable in five years, and a mortgage on his farm to secure it. For its commission the company received his note for $1,000.00, being two per cent on the amount of the principal note for the period of five years. This commission note was due in two years and was secured by a second mortgage on the farm. It was immediately set up at its face value on the company's books as income. The company promptly set about selling the $10,000.00 first mortgage loan. It found a purchaser willing to buy at par if it would give him its usual contract, as advertised, to pay him one per cent of the face of the loan, in addition to the rate of interest it bore, until maturity. The company thereupon endorsed the principal note without recourse and assigned the mortgage and executed its contract to pay the additional one per cent and delivered these papers to him. If the loan were sold and transferred and the contract issued and delivered the same day that the farmer signed the note and mortgage, the amount of the obligation evidenced by the contract would be $500.00. In practice there was necessarily some delay between closing the loan with the

farmer and the sale of it to the investor. Assuming that this might be as much as three months, the obligation evidenced by the bonus contract would then be $475.00. The amount of this contract, whatever it was, was at once charged on the company's books as indebtedness and a liability, and the same amount was placed to the credit of the investor. At the close of such a transaction, the company would have back its $10,000.00 for the purpose of making a new loan. Its gross income account would show a gain of $1,000.00, representing its commission for making the loan. Its expense or liability account would show an item representing the amount of the bonus contract, somewhere between $475.00 and $500.00 in the case supposed above, and depending upon the length of time between the date of the mortgage note and the date of the contract. Disregarding interest and all overhead or other items of expense, the company's books would then show a gain or profit on the transaction of from $500.00 to $525.00, being the difference between $1,000.00 and the amount of the bonus contract. This is the condition at the full conclusion of the transaction. The company has received all it ever will receive out of such loan, and has had all the expense it ever will have in connection therewith. Surely the amount of the bonus contract is expense incurred in the production of the $1,000.00 of gross income. But whatever its nature, it is as fully, finally and definitely in-

curred by the company at that time as it ever will be, and, therefore, if deductible from gross income at all, must be deductible in the year in which it is executed and the obligation and liability which it evidences is created.

But if it be said that only the amount actually paid on such bonus contract is deductible then in the supposed case the payment in the year the contract was executed would be probably $75.00, and could not possibly be more than $100.00. If this be deducted from the $1,000.00 commission note, there remains a gain or profit in the transaction of not less than $900.00, or possibly any other amount between that and $1,000.00. This would make the company pay tax on a gain of $900.00 or more on such transaction, whereas in truth and in fact its gain was only $500.00 or some other amount between that and $600.00. The error of this method and its gross unfairness to the taxpayer is manifest.

Third Proposition

By reason of the fact that the company kept its books and made its return for taxation on an accrual basis, the total of the bonus contracts issued during the year for the full amount of the obligation or liability which they constituted to the company, was deductible from gross income in that year.

Under the provisions of Sec. 13 (d) of the statute quoted above, a corporation may keep its books of account and make its return upon a basis other than actual receipts and disbursements unless such other basis does not clearly reflect its income. In practice, so far as counsel for appellant has knowledge, but two methods or bases for making returns are recognized by the Commissioner of Internal Revenue. One is the cash receipts and disbursements basis, and the other is the accrual basis. Under the former, nothing is counted as income until it is actually received by the taxpayer, and nothing is deductible as expense until he has actually paid it. Under the latter, all gain is included in income at the time the taxpayer's right to it is established, even though it is not actually received or receivable until a later year, and likewise all items of expense are set up as a liability as soon as the taxpayer has become bound and liable to pay them, and are deducted from gross income for the current year, even though they may not be paid nor payable until a later year. In the instant case, the company used the accrual basis of keeping its books and making its returns. Under the authority of the Revenue Act of 1916 and the Revenue Act of 1917, the Commissioner of Internal Revenue promulgated Regulations No. 33 Revised, which were designed to be an interpretation and guide for the taxpayers and the Commissioner in the administration of those acts. Arts. 126, 127 and

128 of Regulations 33 Revised relate to the right of a corporation taxpayer to keep its books and make its return upon an accrual basis. They are as follows:

"Art. 126. 'Paid' or 'Actually Paid.' 'Paid' or 'actually paid,' within the meaning of this title, does not necessarily contemplate that there shall be an actual disbursement in cash or its equivalent. If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash, provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis.

"If in the course of its business, a corporation credits the accounts of individuals, firms or corporations with the amount of any expenses, interest, rentals, wages, etc., due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred are vouchered in definite amounts, the amounts so credited or vouchered may be treated as paid, and if the amounts so credited or vouchered are expenses incurred concurrently with and in the production of the income of the year, they may be allowably deducted therefrom.

"This ruling must not be construed to allow as a deduction any accrued charges which if paid in cash or otherwise would not be deductible.

"Art. 127. Approved Accounting Practices. Pursuant to the foregoing provision, corporations keeping their accounts in strict accord with the methods prescribed by municipal, state or federal authorities, or in accord with approved standard accounting practices consistently followed from year to year, will be permitted to make their returns of annual net

income on the basis of the accounts so kept, provided such systems of accounting clearly and correctly reflect the net income of each year.

"Charged Against Current Earnings. All expenses, including interest, taxes and other necessary charges, incidental and necessary to the creation or production of the gross income or properly chargeable against the same, being deductible from the gross income, whether paid in cash or entered on the books as a liability, can not, if unpaid, be carried forward to be deducted from the gross income of a subsequent year.

"Each Year's Return Complete. Each year's return, both as to income and deductions therefrom, must be complete within itself. Charges, of whatever character, against income can not be cumulative. They must be deducted from the income of the year in which incurred or not at all. The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year.

"The deductions must in all cases be such as are authorized and within the limits fixed by law.

"Art. 128. Previous Year's Charges Not Deductible. A corporation having the right under this rule to deduct all authorized allowances, whether paid in cash or set up as a liability, it follows that if it does not within any year pay or accrue certain of its expenses, interest, taxes or other charges, and makes no deduction therefor, it can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities.

* * * * * * * * *

"Any system of accounting which is not consistent with the purpose and intent of the rules set out in this title, and with the general rules set out in these

regulations for the ascertainment of net income, will not be accepted as a correct basis for making returns."

On January 8, 1916, Treasury Decision 2433 was approved and issued by the Secretary of the Treasury. This treasury decision quotes Sec. 13 (d), as given above, and reads as follows (italics ours):

"Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, *provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made*, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

"In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some federal, state or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, *the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred*, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate, as nearly as can be determined, the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided if it shall be found

that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments or other capital obligations constitute allowable deductions from gross income.

"This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it insofar as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

"If upon investigation, it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements.

"The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which

losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off."

In the cases of *United States* v. *Anderson et al*, and *United States* v. *Yale & Towne Manufacturing Co.*, decided January 4, 1926, 70 L. ed. 142, the Court had under consideration Secs. 12 (a) and 13 (d) of the Revenue Act of 1916, which are the applicable statutes here. In deciding the Yale & Towne case the Court said:

"Standing by themselves and taken at their face value, these sections would seem to require the taxpayer to make his return on the basis of receipts and disbursements, or, in the alternative, on the basis of its own books of account if they reflect true income, under such regulations as the Commissioner may make, and indeed, to require the latter alternative if the taxpayer is unable to make his return on that basis.

"So interpreting the statute, the Commissioner, with the approval of the Secretary of the Treasury, on January 8, 1917, before appellee made its income tax return for 1916, promulgated Treasury Decision 2433, which provides in part that under par. 13 (d) it 'will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.'

"It also provided in substance that when the taxpayer, following a consistent accounting practice, sets up reserves to meet liabilities, the 'amount of which or date of maturity' is not definitely determinable, such reserve may be deducted from gross income. The decision also laid down a procedure for readjusting such reserves when the amount actually required for that purpose was definitely ascertained, and provided that if returns upon this basis of 'accrual or reserves' did not reflect true net income, the taxpayer would not be permitted to make its return on any other basis than that of 'actual receipts and disbursements.'

"We think that the statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent.

* * * * * * * *

"Treasury Decision 2433, to which reference has been made, was in harmony with this view of par. 13 (d). It recognized the right of the corporation to deduct all accruals and reserves, without distinction, made on its books to meet liabilities, provided the return included income accrued, and, as made, reflected true net income. If the return failed so to reflect income, the regulation reserved the right of the Commissioner to require the return to be made on the basis of receipts and disbursements.

"A consideration of the difficulties involved in the preparation of an income account on a strict basis of receipts and disbursements for a business of any complexity, which had been experienced in the application of the Acts of 1909 and 1913, and which made it necessary to authorize by departmental regulation a method of preparing returns not in terms provided for by those statutes, indicates with no uncertainty the purpose of pars 12 (a) and 13 (d) of the

Act of 1916. It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period the expenses incurred in and properly attributable to the process of earning income during that period; and, indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.

"The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year. The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained. The taxpayer being unable to make its return on a strict receipts and disbursements basis, and not having attempted to do so, could not have complied with par. 13 (d) and Treasury Decision 2433 by deducting either accruals of interest or expenses alone without the other, or without deducting other reserves made on its books to meet liabilities such as the munitions tax, incurred in the process of creating income.

* * * * * * * * *

"In the economic and bookkeeping sense with which the statute and treasury decision were concerned, the taxes had accrued. It should be noted that par. 13 (d) makes no use of the word 'accrue' or 'accrual,' but merely provides for a return upon the basis upon which the taxpayer's accounts are kept, if it reflects income—which is precisely the return insisted upon by the government. We do not think that the treasury decision contemplated a return on any other basis when it used the terms 'ac-

> crued' and 'accrual' and provided for the deduction by the taxpayer of items 'accrued on their books.'"

And in deciding the Anderson case, the Court said:

> "But the findings fail to show affirmatively that the books were kept or the return made on the basis of receipts and disbursements. Indeed, the facts found, to which we have referred, show that the books were kept on the basis of accruals and reserves to meet liabilities incurred. It does not appear that there was any expense or liability of the taxpayer incurred by its operations during the year which was not accrued on its books. Its return was made on that basis, but omitted munitions taxes accrued on its books during the year for which the return was made. We think these facts bring the case clearly within the principle which we deem to be applicable to No. 420."

It would seem fully established by the foregoing authorities that where a taxpayer keeps its books and makes its return on an accrual basis all expense incurred in the production of income in the taxable year, for the payment of which the taxpayer becomes obligated, even though not payable until a later year, not only *may be*, but *must be*, deducted from gross income in the year in which the same is incurred. In the instant case, the company's obligation and liability upon its bonus contracts issued in any year are the full face value of such contracts. This value is one per cent of the face of the principal loan to which the bonus contract relates from the date of the contract to the maturity of the loan. This amount the company unconditionally, unequivocally and

absolutely binds itself by its written obligation to pay to the purchaser of the principal mortgage loan. Surely the total of these bonus contracts issued in any year must be deducted at the full amount of their obligation from gross income in that year as expense incurred in producing such income.

Fourth Proposition

The method of the company in keeping its books and making its return on an accrual basis and of deducting from gross income the total full face value of its bonus contracts issued in that year, correctly reflects its income, and it is only by the deduction of the amount of such contracts that its income can be correctly reflected.

One of the most fundamental rules, often declared and rigidly enforced by the Commissioner of Internal Revenue in the administration of the revenue acts, is that income and expense must be treated on the same basis, and that each year's return, both as to income and deductions, must be complete in itself. If a taxpayer accrues income, he must also accrue expenses. If he does not accrue income, he can not accrue expenses. Items of income must be returned in the year in which they are earned, and items of expense must be deducted in the year in which incurred, or not at all. We repeat the following from Art. 127 of Regulations 33 Revised:

"Each year's return, both as to income and deductions therefrom, must be complete within itself. Charges, of whatever character, against income can not be cumulative. They must be deducted from the income of the year in which incurred or not at all. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year."

And in Rgulations 45, issued by the Commissioner for the administration of the Revenue Act of 1918, it is provided in Art. III as follows:

"Art. III. When Charges Deductible. Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See Articles 21-24 and 52. The expenses, liabilities or deficit of one year can not be used to reduce the income of a subsequent year. A person making returns on an accrual basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges and makes no deduction therefor, he can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities."

And in Law Opinion 1059, promulgated by the Solicitor of Internal Revenue, Cumulative Bulletin 4, pages 147, 151, we find the following (italics ours):

"The method of keeping this account discloses that instead of a general reserve being set up as an extra safeguard to take care of a possible but un-

known liability, the company accrued from month to month the estimated amount of munitions taxes it was required to pay and so constituted it a liability against the company's assets. This amount should not have been difficult to estimate, it being, as has been stated, twelve and one-half per centum of the net profits received during the year on the manufacture of certain products. Under the accounting method employed by the company, it undoubtedly could estimate with great accuracy its probable profits from munitions operations, even though they could not be absolutely determined. While there may be a technical distinction in accounting between an accrual and a reserve, the setting up of a reserve is not inconsistent with the system of accrued accounting. Neither do I find anything in the law that distinguishes between them. The law looks only to whether the liability was actually incurred and does not prohibit the deduction of a proper reserve set up to meet a known liability that is a proper deduction. Law Opinion 360. Therefore, the fact that the company failed to make an accurate estimate of its munitions taxes for 1916 is not sufficient reason for deducting the amount of such taxes in 1917. *Few accrued liabilities are estimated with absolute accuracy, and it is generally necessary to make adjustments from time to time in these accounts as the situation requires.* This fact is recognized in Treasury Decision 2433.

"We come now to the question of the effect of this treasury decision. It is unnecessary to enter into a discussion of whether under the language used therein corporations were merely given permission or were required to use the accrual system of keeping accounts. It is sufficient to note that this company not only kept its accounts on the accrual basis, accruing munitions and other taxes, but rendered its tax returns on that basis, with the exception that taxes were deducted in the year in which paid. In

this respect there was a departure from the established method of accounting not warranted by the law or regulations. Having elected to report its income subject to tax on the basis on which its accounts were kept, thus taking advantage of Section 13 (d), which brought it within the provisions of this section and Treasury Decision 2433, the company became bound by its election, and having decided to accrue income, it must go the whole way and accrue liabilities instead of accounting for them on a different basis, except where the act specifically provides otherwise. Neither can it use one method in making one deduction, and a totally different method in making another deduction. The reason for this is obvious. Take, for instance, the item under discussion. Munitions taxes are an element of cost entering into every unit of production and which must be taken into consideration each year in computing net income subject to tax. *It is an expense necessary to produce income and income is improperly reflected if the deduction on this account is made the following year, as it is in no way related to the income of the latter year, and has the further effect of greatly inflating the income of the year to which it does relate.* Such practice would be contrary to the provisions contained in the first sentence of paragraph four of Treasury Decision 2433, which contemplates 'that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year,' and to the provisions of Section 13 (d) which permit returns to be made on a basis other than that of receipts and disbursements only when income is properly reflected."

And in A. R. M. 26, Cumulative Bulletin 2, page 115, 116, we find the following language used by the Commit-

tee on Appeals and Review of the Bureau of Internal Revenue:

> "Every consistent practice of accounting requires the establishment and setting up of all liabilities of any nature whatsoever, whenever such liabilities are known or can be accurately determined. Any departure from this well recognized and established practice is in itself a departure from consistency. To the extent that this practice is neglected or ignored, the books of account are manifestly and undeniably in error. Any statement or balance sheet prepared from them would not be a statement of facts, and any income account would not reflect the true income of the company."

Other income tax rulings under authority of the Bureau of Internal Revenue might be cited and quoted to the same effect as the foregoing. It seems unnecessary either from the standpoint of argument or authority to do so. It is clear that in the instant case the amount of the bonus contracts issued must be set up as a liability on the books of the company, just as was in fact done, or its books would be "manifestly and undeniably in error," and "any statement or balance sheet prepared from them would not be a statement of facts, and any income account would not reflect the true income of the company." A balance sheet taken from the company's books which did not show the full amount of its liability under these written contracts, duly signed, sealed and delivered by it, would be a false representation. It would not be a true disclosure of the company's

liabilities. If such a balance sheet were used by the company as a basis for obtaining credit, those extending the credit on the faith of such balance sheet could prosecute the individuals who certified and presented the same as true and correct, for obtaining money or property under false pretenses. The liability of the company, evidenced by its outstanding bonus contracts, must be set up at the full amount thereof on its books as a liability or its books are false.

The liability evidenced by one of these bonus contracts must be deducted in the year in which such liability is incurred or income for that year will not be correctly reflected in its income account. To require the bonus contracts to be deducted as expense in the year in which they are paid, instead of the year in which issued, would distort and misrepresent the income for both years. In a year of large sales of loans direct to investors, the company would, of course, issue a large number of these contracts. They are an expense incidental to the sales. If they are not to be deducted in the year in which issued, the result is to inflate the net income for that year. If they are to be deducted only in the year in which paid, the result is to erroneously reduce net income for that year by deductions from gross income which are not incidental to or in any manner involved in its production. Thus the true net income of the company

is distorted in every year. In some years it is exaggerated and in others understated. The volume of the company's business and its gross income necessarily fluctuate widely in different years, for it is a matter of common knowledge that the farm loan business and the marketing of securities such as farm mortgage notes, is greatly affected by general business conditions. In periods of prosperity, such securities are easily marketed and the company can then do a large volume of business, while in periods of depression it is difficult, and sometimes well nigh impossible, to market such loans without a substantial loss, and the volume of business done is correspondingly small. The only possible method of fairly determining net income in any year is to allow the company to deduct from gross income in that year all expense incurred in producing such income. Any method by which the expense of producing income in one year is carried over and deducted from gross income in another year is bound to be inequitable and unfair to the taxpayer.

The tendency of such method is to make big incomes bigger, and small incomes smaller. It would make the big expense of a big income year deductible in the year of small income, and the small expense of a small income year deductible in the year of big income. The language of Law Opinion 1059, quoted above, is especially apt in defining a bonus contract:

> "It is an expense necessary to produce income, and income is improperly reflected if the deduction on this account is made the following year, as it is in no way related to the income of the latter year, and has the further effect of greatly inflating the income of the year to which it does relate."

The Commissioner has consistently and rigidly enforced the above rule in every case where the taxpayer wanted to carry forward an item of expense from a small income year and deduct it in a year of big income. By the same rule the taxpayer can not be compelled to carry forward items of expense in a big income year and deduct them in a year of small income.

The United States Board of Tax Appeals has declared and applied the same rule as the Commissioner. *In Appeal of Tel. Electric Co.*, 1 B. T. A. 434, 436, after quoting Sec. 13 (d) of the Revenue Act of 1916, the board says:

> "This section permits the taxpayer to keep its books and render its returns upon an accrual basis, and this taxpayer followed that method in keeping its books of account and in reporting its income for 1917 and prior years. The board is of the opinion that the interest on the indebtedness of the taxpayer accrued and became a liability in each of the years 1914 to 1917, inclusive, and constituted proper accrual items, and were allowable deductions in those years; therefore, interest which accrued and became a liability in years prior to 1917 can not be deducted from the gross income of 1917. The fact that the interest was not accrued on its books or deducted in its returns for each of the years when lia-

bility therefor was incurred can not justify the deduction in the return for the year 1917. When a taxpayer elects to report his income on either the cash receipts and disbursements or the accrual basis, he must consistently report his income and deductions on that basis. Otherwise his return would not reflect his true net income. We can find no justification in the law for the deduction in the return for 1917 of the interest which accrued in the years 1914 to 1916, inclusive, when the taxpayer has adopted the accrual method of reporting income."

In *Appeal of Clarence Seibert*, 1 B. T. A. 328, 330, the board had under consideration Secs. 213 (a), 213 (b) and 212 (b) of the Revenue Act of 1918, which are substantially the same as Sec. 13 (d) of the Revenue Act of 1916. It is there said:

"From the foregoing it is clear that the receipt of income is essential to constitute it taxable income only in case the taxpayer so accounts in his system of bookkeeping. It is specifically provided by the act that if the taxpayer accounts on a different method the income shall be reported in accordance with such method and that receipt is not then the determining factor. The taxpayer urges that he neither actually received this salary nor constructively received it. He admits that the method of accounting regularly employed by him in keeping his books of account was the accrual system. Under such system of accounting receipt of income—actual or constructive—is not essential to constitute it income within the statutory definition of income. Under an accrual system of accounting one accrues income, he does not receive it. Under the receipts and disbursements method, one receives income and does not accrue it. Both methods of accounting have their advantages, as well as their disadvantages,

to a taxpayer according to the circumstances of each taxpayer. It is not necessary to go into this—it is well understood. But having adopted a method of accounting and having regularly employed that method in keeping his books, a taxpayer is compelled by law to report income in accordance therewith."

See, also, *Appeal of John W. Butler, Inc.*, 1 B. T. A. 1165; *Appeal of North Wayne Tool Co.*, 2 B. T. A. 308, and *Appeal of Sauer-Bagley Lumber Co.*, 3 B. T. A. 927. It would serve no useful purpose to multiply authorities on this point.

We conclude, therefore, that the only possible method by which the company's books will correctly reflect its net income, is that of setting up the full amount of the home contracts issued by it in any year as a liability and deducting the same from its gross income for that year.

Fifth Proposition

The Commissioner at one time held that these home contracts were for the payment of interest, and later that they were contingent obligations for an indefinite and unascertainable amount. Both of these positions are erroneous.

Interest is compensation for the use or forbearance of money. The payment of interest presupposes indebt-

edness in some principal sum of the payor to the payee. Again, interest is not a liability in any fixed amount created or existing at the time the principal indebtedness upon which it is based is created. The liability for interest arises or accrues only with the lapse of time and is measured in amount by the length of time that the principal sum of money is used or detained. Each day of time that passes creates the obligation to pay an additional day's interest. Where money is borrowed for a term of years at a fixed rate of interest, the liability for the interest for the whole term of years is not created and does not arise at the time the money is borrowed. Nor is it an obligation incurred at that time for the use of the money for the whole period. The interest for each day or month or year of time that passes is payment for the use of the money during such period. Where borrowed capital is used in business and in the production of income, the interest for each year is a deductible item of expense from income in that year. It is a payment for the use of the money during such year, and as an item of expense it can not be carried either backward or forward and deducted from the income of another year, for the reason that it has no relation to the use of the principal sum in the production of income in such other year. This rule is fully recognized in a number of decisions of the United States Board of Tax Appeals. The Board

has defined interest as an expense which accrues ratably over an elapsed period of time. *Appeal of Tel.-Electric Co.*, 1 B. T. A. 434; *Appeal of Chatham & Phenix National Bau*, 1 B. T. A. 460; *Appeal of North Wayne Tool Co.*, 2 B. T. A. 366; *Appeal of Cumberland Glass Manufacturing Co.*, 2 B. T. A. 1122; *Appeal of Sauer-Ragley Lumber Co.*, 3 B. T. A. 927.

It must be clearly understood that the bonus contracts of the company are not interest payments. To help in this understanding the following definitions of interest are submitted:

> "Interest is the compensation allowed by law, or fixed by the parties, for the use or forbearance of money, or as damages for its detention." 22 Cyc. 1469.
>
> "Interest is the compansation allowed for the use or forbearance or detention of money, or its equivalent." Sec. 1002, Revised Laws of Oklahoma, 1910.
>
> "The compensation which is paid by the borrower of money to the lender for its use, and generally by a debtor to his creditor in recompense for his detention of the debt." Bouv. Law Dict. (Quoted with approval in *Hubbard* v. *Callahan*, 42 Conn. 524, 528, 19 Am. Rep. 564; *Sorenson* v. *Central Lumber Co.*, 98 Ill. App. 581, 582; *Williams* v. *Scott*, 83 Ind. 405, 408; *Hale* v. *Forbis*, 3 Mont. 395, 405.)
>
> "A compensation taken for the loan or use of money." *Turner* v. *Turner*, 80 Va. 379, 381.
>
> "A compensation for the detention or use of money. *Stokely* v. *Thompson*, 34 Pa. St. 210, 211.
>
> "The compensation allowed for the use or for-

bearance or detention of money, or its equivalent." *Davey* v. *Deadwood First Nat. Bank*, 10 S. D. 148, 72 N. W. 83.

"Money to be paid for the use of capital, on a loan of money, or the forbearance of a debt, and becomes part of and incident to a debt; or it is damages for the detention of a debt due, and fixed by law at a given rate, in proportion to the amount of money lent, or detained, and the time for which it is thus lent or detained." *Corcoran* v. *Henshaw*, 8 Gray (Mass.) 267, 268.

"The compensation which may be demanded by the lender from the borrower, or by the creditor from the debtor, for the use of money." *Ward* v. *Brandon*, 1 Heisk. (Tenn.) 490, 492.

"A legal and uniform rate of damages allowed in the absence of any express contract when payment is withheld after it has become the duty of the debtor to discharge his debt." *Waller* v. *Kingston Coal Co.*, 191 Pa. St. 193, 201, 43 Atl. 235.

"The price agreed to be paid for the use of money." *Bledsoe* v. *Nixon*, 69 N. C. 89 91, 12 Am. Rep. 642.

"The compensation allowed by law or fixed by the parties to a contract for the use or forbearance or detention of money." *Parks* v. *Lubbock*, 92 Tex. 635, 637, 51 S. W. 322.

"The premium allowed by law for the use of money." *Garr* v. *Louisville Banking Co.*, 11 Bush (Ky.) 180, 189, 21 Am. Rep. 209.

"The compensation which the borrower pays to the lender for the profit which he has an opportunity of making by the use of the money." *Hammond* v. *Hammond*, 2 Bland (Md.) 306, 307.

"A certain profit for the use of the loan." *Dry*

Dock Bank v. *American L. Ins., etc., Co.*, 3 N. Y. 344, 355.

"A compensation allowed to the creditor for delay of payment by the debtor." *Kelsy* v. *Murphy*, 30 Pa. St. 340, 341.

"A profit or recompense allowed to be taken from the borrower by the lender." *State* v. *Multnomah County*, 13 Ore. 287, 294, 10 Pac. 635.

The foregoing does not by any means exhaust the number of judicial definitions of the term *interest*, but inasmuch as there is no substantial difference among the authorities, additional citations would serve no useful purpose. It will be noted that in all these definitions, before interest can come into existence, one person must owe another money, either as a borrower or as a debtor from some other cause. For the use or detention of this money the debtor pays or is obligated to pay his creditor a sum in addition to the original debt, which sum is called interest.

In the instant case the original relation between the company and the investor is that of seller and buyer. The company sells and endorses to him without recourse an interest-bearing real estate mortgage note, which he pays for. The company has not borrowed any money, nor has the investor loaned any. The company is not obligated to him at all on account of the note purchased, and is not his debtor in any sum. It has merely received the pay for what it sold and delivered. The title and

ownership of the mortgage note has been transferred by a purchase and sale. *There is no principal debt of the company on which it must or can pay interest. There is no debt of the company at all to the investor until it gives its bonus contract and none then except that contract itself.* Hence, it is plain that these bonus contracts are not interest payments and do not represent a liability for interest.

We hope that we have made clear the nature of these bonus contracts. They are not interest obligations, but are purely an expense of the company in selling its merchandise, viz., mortgage loans. They are a premium or bonus to its customers in consideration of their patronage, and are given as an inducement or added consideration to them to buy. They recite that "in consideration of the purchase" of the loan in question, the company agrees to pay the amount specified, hence they are a mere promise to pay a principal sum for a valuable consideration received.

Neither are the bonus contracts contingent or conditional. They embody an absolute, unqualified and present promise of the company to pay a sum certain, or that is made certain by reference to another instrument, in money each year for a fixed number of years. The liability of the company under such a contract attaches immediately upon the execution and delivery of the con-

tract. It is true that the term of years for which the annual payments are to be made may be shortened from that which appears on the face of the instrument. If that happens, then at that time the amount to be paid under the contract will be diminished; but that is merely a lessening of the liability after it has attached, and is not a condition or contingency upon which the attaching of the liability depends. In other words, the liability on the part of the company is not created by nor dependent upon the happening of a future event, but such liability is subject to be defeated in part upon the happening of a future event, which may possibly, but will not certainly, come to pass.

An example of a contingent or conditional liability is found in the case of an endorser on a promissory note or of a guarantor or surety on a contract of guaranty or suretyship. No present liability attaches to an endorser on a note at the time of the endorsement thereof. His liability depends upon and is created by the happening of a future event which may or may not come to pass. If the maker of the note pays it at maturity, the endorser never incurs an absolute liability thereon. If the maker does not pay at maturity and it is duly presented for payment, protested for non-payment and notice of protest given the endorser, where this procedure is not waived, then the endorser does become liable for the

amount due on the note. The same is true in the case of a contract of a guarantor or surety. Liability attaches to him on his contract only when and in the event that his principal defaults in his obligation. These are illustrations of contingent or conditional contracts. Their characteristic is that they do not become fully operative or absolute until, and then only upon, the happening of some contingency. We submit herewith the following definitions from 1 Bouv. Law Dict. 421:

> "CONTINGENCY. The quality of being contingent or casual; the possibility of coming to pass; an event which may occur. Webster. It is a fortuitous event which comes without design, foresight or expectation, 39 Barb. 272.
>
> * * * * * * * * *
>
> "CONTINGENT. When applied to a use, remainder, devise, bequest or other legal right or interest, it means that no present interest exists, and that whether such interest or right ever will exist, depends upon a future uncertain event. The legal definition of the word concurs with its ordinary acceptation in showing that the term contingent implies a possibility: 5 Barb. 692."

It is true of the company's bonus contracts, as already stated above, that the amount to be paid thereunder, is subject to a condition or contingency which may reduce the same. Perhaps the most precise definition of this provision would be to call it a condition subsequent. Clearly, it is not a condition or contingency upon which the attaching of liability to the company de-

pends, for that liability is created when the contract is made and delivered. It is a condition or contingency upon the happening of which the liability of the company already created may be in part cancelled and so diminished. The following definitions of "condition" are submitted from 1 Bouv. Law Dict. 382, 383:

> "CONDITION. A qualification, restriction or limitation modifying or destroying the original act with which it is connected.
>
> "A clause in a contract or agreement which has for its object to suspend, rescind, or modify the principal obligation, or, in a case of a will, to suspend, revoke or modify the devise or bequest.
>
> * * * * * * * * *
>
> "A future uncertain event on the happening or the non-happening of which the accomplishment, modification or recission of a testamentary disposition is made to depend.
>
> * * * * * * * * *
>
> "Subsequent conditions are those whose effect is not produced until after the vesting of the estate or bequest or the commencement of the obligation."

We think the latter definition applies to the provision in the company's bonus contracts to the effect that they terminate upon prepayment of the mortgage bonds to which they refer. The effect of this condition in the contract is not produced until after the commencement of the company's liability. It has nothing to do with the creation or commencement of this liability, but merely states a condition which, if it comes to pass, will de-

feat or terminate the liability of the company, already created, after the date on which it happens. We submit that under the law and regulations the correct method for the company to handle these bonus contracts on its books is to set them up as a liability at their maximum or full face value, and then, if the condition subsequent provided therein, viz., the prepayment of the mortgage bond to which a given contract relates, should happen, to treat the unpaid portion of such contract as income in that year, and that this is the only method that will reflect the financial condition of the company at all times and will correctly reflect its income and expenses in any year.

The bonus contracts are not negotiable, within the strict legal definition of the term, because they are not complete in themselves, but must be construed in connection with the mortgage bonds to which they relate. They are, however, valid contracts, and as such are assignable.

It must be conceded that the bonus contracts represent an expense incurred in the production of income. It has been shown that each contract relates solely to income of the year in which it is issued. These contracts are of the same character as trading stamps or premium coupons or profit-sharing certificates issued by a merchant to customers on purchases made by them.

Both forms of obligation are for the purpose of stimulating trade by giving the customer a bonus or added consideration for his purchase. Both contracts represent an unqualified, unconditional and absolute promise of the maker to pay. The right to deduct the amount of the liability thus created from gross income as a business expense has always been recognized by the Commissioner. Art. 141 of Regulations 33 Revised reads in part as follows:

> "Art. 141. Redemption of Trading Stamps. Corporations, mercantile or otherwise, which issue trading stamps, coupons, etc., for the purpose of increasing their business, which stamps or coupons are redeemable in merchandise, may allowably deduct from gross income as a business expense the amount which such corporations actually expend for such stamps or coupons, and also the actual cost to the corporations of the merchandise given in redeeming the same."

In the case of trading stamps, premium coupons or profit-sharing certificates, it is a well known and recognized fact that a considerable portion of those issued will never be presented for redemption or payment. In the case of the company's bonus contracts there is a possibility that by reason of the prepayment of a few of the mortgage notes to which they relate, the company will not be required to pay all of such contracts in full. Yet the principle that the amount which the merchant in the one case, or the company in the other, will ulti-

mately have to pay on the obligations mentioned, as nearly as the same can be ascertained, is an expense incurred in business and deductible from income in the year in which the obligations are created, has already been established herein and is fully recognized by the Commissioner.

In order to meet the condition created by the fact that a fairly uniform percentage of trading stamps issued will never be presented for redemption, the Commissioner, in promulgating Regulations 45, changed the rule somewhat from that laid down in Regulations 33 Revised. Art. 88 of Regulations 45 reads as follows:

> "Art. 88. Subtraction for Redemption of Trading Stamps. Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons redeemable in merchandise or cash, he should in computing the income from such sales, subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing: (a) the total issue of stamps during each year, (b) the total stamps redeemed in each year, and (c) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar state-

ment shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required."

Thus we see that in the case of the merchant the method now prescribed is to estimate in the light of previous experience in his business and of other merchants in similar businesses, the percentage or proportion of trading stamps, premium coupons or profit-sharing certificates that will never be presented for redemption or payment, and to deduct this from the total amount issued in any year, and then allow the remainder as a deductible expense. This rule, based on business experience, is not applicable in the case of the taxpayer here, for the reason that there is no approximate uniformity over a period of years in the volume of its business, or the number of bonus contracts issued, or the percentage thereof extinguished by prepayment of the principal mortgage debt in each year. General business conditions of prosperity or depression, of easy money or tight money, of high prices or low prices, affect the percentage of mortgage notes which are paid off before maturity. This percentage might be very low in a given

year or for several years, and then be much higher in another year or group of years.

It would seem that the method adopted by the company of deducting the total of its home contracts as expense in the year in which given and then crediting back to income any portion thereof from the payment of which it becomes relieved in a later year, is equally as fair and satisfactory in results as the rule of experience applied in the case of trading stamps, and has the advantage of using exact figures and computations instead of an estimate.

This method can be used effectively by the company for the reason that, in the case of every home contract, its liability is fixed and not subject to be diminished in approximately two years thereafter, and nine times three, and will be fully matured and due and payable in approximately five years thereafter. While in the case of the merchant issuing the trading stamps, premium coupons or profit sharing certificates, there would be no time limit to his liability thereon. They would be redeemable or payable on demand and the statute of limitations would not begin to run in favor of the merchant until they had been presented for redemption or payment and the same had been refused. Therefore, there is no feasible or practicable way of determining when the liability of the merchant for such trading

stamps, premium coupons or profit-sharing certificates would terminate. He could always truthfully claim that they were an outstanding liability against him, and consequently there would never come a time when it could be said that he was relieved from liability on account of them and their amount should be restored to income. But since it is a known fact that many of them will never be presented for redemption, in order to ascertain a proper and just sum to allow him, as an expense deduction on account of his liability for them, the Commissioner has adopted the rule of allowing an estimate to be made based on experience in the business. It is clear that the method of determining the amount of the deduction of the merchant on account of trading stamps, premium coupons and profit-sharing certificates issued by him by an estimate of the amount thereof that will probably never be presented for redemption or payment, is based upon necessity, and that in the case of the company's business here involved, no necessity for using an estimate exists. The exact value of any cancelled honorarium at the time of cancellation can readily be ascertained, and this value when ascertained can then be credited to income. Likewise, the exact time at which it will be paid or cancelled is fixed and known. But until cancelled, such contract is an absolute and unqualified obligation of the company. When cancelled, but not until then, it may be included in income.

The argument of the Commissioner is that since the mortgage notes sold by the company provide that the borrower may pay them off after two or three years, without waiting for their maturity, and since the bonus contracts obligate the company to pay the percentage specified therein only during the life of the loan, therefore, the bonus contracts represent only a contingent liability which the company may never be called upon to pay, and which should not be allowed as a deduction until it has been made a fixed charge by actual payment. There is no substantial merit in this position.

The company's obligation is absolute. It must meet the payments called for in the contract "during the life of said loan." The ordinary, usual and natural life of the loan extends to the date of its maturity. The company must assume that the loan will run that long and be prepared to meet its liability accordingly. Neither the company nor the investor who buys the loan can do anything to shorten its life. The only person who can shorten its life is the borrower, and to do so is a mere privilege, not a duty, with him, and this privilege does not arise until after the loan has run for two or three years. The fact that the notes have a prepayment privilege after two or three years does not give rise to any presumption that any of them will be paid before maturity. If they contained no such prepayment privilege,

then the argument that the company could not accrue its bonus contracts as expense, because it might not have to pay all of them, would be wholly without foundation. And yet without a prepayment privilege provided for in the notes, they could be paid before maturity at any time that the borrower wanted to pay and the holder of the note was willing to accept the money. Probably also about as large a percentage of them would be paid before maturity in that manner without the prepayment privilege as are actually paid under its provisions. In any event, the company's liability on its bonus contracts is fixed and certain for two years or for three years, according to when the prepayment privilege in the mortgage note first becomes available to the borrower, unless the borrower wants to pay it earlier and the holder of the note voluntarily accepts payment.

But whenever one has been paid, the company has taken up its bonus contract on that loan and has credited the amount of the unpaid balance thereon to income in the current year. This method of accounting has been consistently followed by the company ever since it began to execute bonus contracts. The total of these contracts in each year has been accrued as liability and expense in that year, just like brokerage fees, and has been deducted from gross income in arriving at the net. Then if in any subsequent year any one of these contracts was

terminated by prepayment of the mortgage note to which it related, the amount unpaid on such contract was then credited to income.

We submit that this is the correct and only practicable method of handling these bonus contracts on the company's books of account. They are liabilities, and, "Every consistent practice of accounting requires the establishment and setting up of all liabilities of any nature whatsoever." A. R. M. 26, 2 Cum. Bull. 115, 116. Each contract remains a liability until it is terminated by prepayment of the mortgage note to which it relates. Then, but not until then, can it be charged off as a liability. And when thus charged off as a liability, as a part of the same transaction, it is properly credited to profit and loss or income. This is the only method possible of keeping the company's books in respect of these items so that they will reflect its true income in any year and so that a balance sheet prepared from them would be a statement of facts.

The position taken by the Commissioner, followed to its logical extreme, would absolutely preclude the setting up of any indebtedness payable in the future as a liability or an accrued expense. As to any such indebtedness, there is always the possibility, however remote, that the creditor will forgive the debt or for some reason may not demand and exact payment of it. There-

fore, no unpaid debt or expense of a taxpayer, no matter what its nature, should ever be allowed as a deduction from gross income in advance of its actual payment, because there is always some possibility that for some reason he may never have to pay it. This illustration is extreme, but it shows the fallacy of the Commissioner's position, for according to it there could be no such thing as accrued expense.

In the present case the possibility that the company may be relieved from payment of a part of the indebtedness on a few of its bonus contracts is not so remote as in the case of an ordinary debt or bill payable for expense. But there is no distinction in principle between the two cases, the difference in the possibility that payment will not be required being one of degree only.

We submit that notwithstanding the possibility that the company may never have to pay all of its obligation on a few of its bonus contracts, they are still deductible as accrued expense in the year in which they are given.

Sixth Proposition

The only correct method by which the company can keep its books so that they will at all times show its true financial condition is to set up all of its liabilities, including its outstanding bonus contracts at their face value,

and then, if and when any portion of such liability is extinguished by a prepayment of a mortgage note to which a bonus contract relates, to restore the amount of such liability, thus cancelled and extinguished, to income at that time.

The situation presented is exactly analogous to that where a corporation issues its promissory note or bond for the payment without qualification or condition of a sum of money at the end of a term of years. The amount of this note or bond at once becomes a liability and must be so shown upon its books. It might happen that in consideration of the payment of the note or bond before maturity, the corporation would be granted a discount, thus settling a liability for less than its face. In such case, the amount of this discount is gain or income in the year of the transaction.

In the case of the taxpayer here, when one of its mortgage loans is prepaid and it is thereby relieved from further payments on the bonus contract which accompanied such mortgage loan, the situation is the same as if it had retired an obligation before maturity at a discount. The amount of such discount is gain or income in the taxable year in which the obligation is so retired. If the company gave its bonus contract for $250.00 accompanying the sale of a mortgage loan for $5,000.00 and at the end of three years the loan was paid

off and discharged, the $100.00 unpaid on such bonus contract would be to the company as a discount upon its obligation retired before maturity, and would constitute gain and income. The correctness of this procedure is fully recognized in the regulations promulgated by the Commissioner. In Art. 544 of Regulations 45 it is said:

> "Art. 544. Sale and Retirement of Corporate Bonds. (1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (b) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value, is a deductible expense for the taxable year. See Section 234 of the statute and Article 563. (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

This is in harmony with the way the company has kept its books and with its contention in the matter now under consideration. It accrues its bonus contracts, which are its bonds, as an expense at the issuing price or face value thereof. If one of these bonus contracts or bonds is retired before maturity, due to the exercise by the maker of the mortgage loan of the prepayment privilege therein, then the difference between the issuing price or face value of such bonus contract or bond and the amount paid by the company thereon to the date of

payment of the mortgage loan, is discount that accrues to the company by retirement of its obligation before maturity, and is gain or income for the year in which the transaction occurs.

A similar principle is applied in the case of bad debts. Among the deductions from gross income for any year in arriving at a taxpayer's taxable net income are bad debts or accounts determined to be worthless and charged off on his books within the year. Bad debts are not exactly a business expense, but they are recognized as incidental to and inseparable from the conduct of almost every business. That they are deductible has been recognized in all the revenue acts and all the regulations. Art. 151 of Regulations 33 Revised reads in part as follows:

> "Art. 151. Bad Debts. Losses which may be properly deducted from gross income on account of bad debts or doubtful accounts are those losses which have been definitely ascertained to have occurred and which were charged off during the year for which the return is made."

But it sometimes happens that a bad debt determined to be worthless and charged off is recovered in whole or in part in a later year. When this happens the amount of the recovery is income in such year. This is in harmony with the company's method of restoring to cur-

rent income the unpaid portion of any of its bonus contracts from the payment of which it is relieved by prepayment of mortgage loans. The rule as to the recovery of bad debts is stated in Art. 110 of Regulations 33 Revised, which reads as follows:

> "Art. 110. Bad Debts Recovered. Bad debts or accounts charged off by a corporation because of the fact that they were determined to be worthless, and subsequently recovered, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. Neither the date at which the debt was charged off nor the fact that it was or was not deducted from gross income in any return made for tax purposes, will in any way affect its character as income of the year in which recovered."

Thus we see that for a bad debt to be deductible it is not necessary that every possibility of the ultimate recovery of all or a part of it should be excluded. So in the case of the company's bonus contracts it is not necessary, in order that they should be deductible from current income, that every possibility of the ultimate release from payment of any part of them should be excluded. If it is reasonably certain that they will have to be paid, they are a deductible expense then. And as in the case of bad debts, if it turns out in the future that a part of the liability evidenced by them is extinguished without payment, the same becomes gain and income in that year.

As stated in the findings of fact, the notes received by the company as payment for its services in making loans to its borrowers are accrued and set up as income in the year in which received. This is done notwithstanding there is a possibility that such notes may not be paid at maturity or at all. This is a possibility which not infrequently materializes. These notes, as stated, are usually secured by a second mortgage on the land securing the principal loan. If a serious depression in the business of farming ensues it may well happen, and often does, that the borrower is unable to meet his interest obligations on the principal loan, and also pay these commission notes. And it also sometimes happens that the value of farm lands declines, so that the farm itself becomes of insufficient value to pay more than the first mortgage in the event of foreclosure. This is actually happening right now in respect to a large number of the commission notes which the company took while engaged in active business. In such case, or whenever from any cause a commission note proves uncollectible and worthless, it is charged off and deducted as a loss in the year it is so determined to be worthless. And if in a later year such note should finally be paid in whole or in part, which has sometimes happened, the amount so paid upon it is credited to income in that year. If this is the correct accounting method on an accrual basis for handling the commission notes received by the com-

pany as compensation for its services, and no one can dispute that it is, then by every rule of consistency in accounting, the method followed of setting up the bonus contracts as liabilities and expense incurred and accrued in the year in which issued and deducting the same from income in that year, and then, if in a later year a part of the liability on such bonus contract is extinguished by prepayment of the principal loan to which it relates, of crediting the amount of such liability so extinguished back to income in that year, is the only correct and approved method for handling such contracts.

It must be borne in mind that the mortgagor in the principal loan merely has the permission or privilege to pay off his loan before maturity and is not under any obligation to do so. In the nature of things the number of such mortgage loans paid before maturity would be exceedingly small. It is shown that the usual commission charged by the company for making loans to its borrowers was two per cent per annum for the life of the loan. This commission was fixed, charged and collected at the time the loan was made, either in cash or in commission notes. It is not reasonable to suppose that the borrower, having paid the full commission charge for his mortgage loan for a period of five years, would voluntarily pay the same one year or two or three years before maturity and lose the benefit of the com-

mission paid for its use for such longer period. Such a thing *might* be done in a rare and peculiar case where some emergency arose which made it desirable to the borrower to have his property cleared of the mortgage debt. It is a matter of common knowledge that in business transactions men seek to get the most that they can for their money, and that when they have paid the full price for benefits and advantages, they expect and exact the full enjoyment and fruits of them. Applying this rule to the facts of the instant case, it must appear that the number of the mortgage loans which would be paid off before maturity, resulting in relieving the company from a part of its obligation on bonus contracts, would be so small as to be well nigh negligible.

In any event, if it be assumed on the one hand that the commission notes to the company will be paid at maturity and that, therefore, they are to be included in income in the year in which received, which must be done in keeping its books on an accrual basis, what reason or warrant of authority can there be for a contrary assumption on the other hand that the mortgagors in the mortgage loans to which the bonus contracts relate will pay them before maturity and thus relieve the company of a part of its liability on such contracts? There is in fact as much likelihood of default in payment of the commission notes as there is of prepayment of the first

mortgage notes, but in any event, for the company's bookkeeping to be consistent, they must be handled on the same basis. The commission notes must be set up as income, and if later they become uncollectible, then be charged off as a loss when that fact is determined. The bonus contracts must be set up as an expense and liability at their full amount, and if later the company is relieved of a part of that liability, then the amount thereof be included in income at that time.

No other method is possible that will truly disclose the company's income in any year or its financial condition at any time. If, for example, the company on July 1, 1917, sells a mortgage loan for $10,000.00 to an eastern investor, and such loan still has four and one-half years to run, then by its bonus contract, which accompanies such sale, it would be obligated to pay $50.00 to the purchaser for the first year and $100.00 each year thereafter for four years. If the $450.00 which it thus bound itself to pay was not deductible from income in 1917, it would, as the Commissioner contends, be deductible $50.00 in that year and $100.00 each year thereafter for four years until paid. The result of this would be that in 1921 the company would pay $100.00 on such contract and would deduct the same from gross income in that year, although such payment had not the slightest thing to do with the production of income in that

year, and was not a business expense in any sense in that year.

This method seems so obviously wrong that it is difficult to make an argument upon it consisting of more than the repeated assertion that it is obviously wrong. How can it be said, where the company has issued its written obligation and promise to pay a sum of money over a certain period of time, that this is not a liability which must be set up at its full amount on its books in order for its books to show the truth? How can it be said that the bonus contracts are not a business expense incurred in the year in which they are executed? How can it be said that its net income in any year is correctly determined when expense incurred in producing income in one year is carried over and deducted from gross income in another year, with the production of which it had no connection whatever?

CONCLUSION

Upon the facts as stipulated by the parties and found by the trial court, and upon the authorities and argument presented above herein, the appellant says that the judgment of the trial court should be reversed and the cause remanded with directions to enter judgment in

its favor for $4,750.76, with interest thereon at the rate of 6% per annum from December 30, 1922 (R .10).

In the opinion of counsel for the appellant, there can hardly be a doubt of the correctness of its contentions. But in the event that the question involved might be considered doubtful, we call the Court's attention to the oft-repeated rule that in tax cases where there is room for grave doubt as to whether or not tax liability exists, such doubt is to be resolved in favor of the taxpayer and against the Government, and the taxpayer be relieved from tax liability. This rule is equally applicable to questions of fact and of law. *American Net & Twine Co.* v. *Worthington*, 141 U. S. 468 474, 12 Sup. Ct. 55, 35 L. ed. 821; *Benziger* v. *United States*, 192 U. S. 38 55, 24 Sup. Ct. 189, 48 L. ed. 331; *Gould* v. *Gould*, 245 U. S. 151, 38 Sup. Ct. 53.

Respectfully submitted,

STREETER B. FLYNN,
CHAS. H. GARNETT,
For the Appellant.

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In the Supreme Court of the United States

OCTOBER TERM, 1926

No. 167

AMERICAN NATIONAL COMPANY, AS RECEIVER FOR the F. B. Collins Investment Company, appellant

v.

THE UNITED STATES OF AMERICA

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE WESTERN DISTRICT OF OKLAHOMA

BRIEF FOR THE UNITED STATES

OPINION BELOW

No opinion was delivered by the court below.

JURISDICTION

The suit was brought in the District Court after claim for refund had been rejected, to recover $4,750.76 with interest, the amount of an income and excess profits tax for the year 1917, alleged to have been erroneously assessed. The jurisdiction of the District Court was invoked under Section 24, paragraph 20, of the Judicial Code, giving the District Court concurrent jurisdiction with the

Court of Claims. Sitting as a Court of Claims, the court heard the case upon an agreed statement of facts, which it adopted as its findings, and rendered judgment in favor of the United States. (R. 12, 13.) The judgment was filed March 30, 1925 (R. 12), and the appeal allowed June 18, 1925. (R. 13.) Direct review by this Court is therefore proper. *J. Homer Fritch, Inc.,* v. *The United States,* 248 U. S. 458.

QUESTION PRESENTED

The F. B. Collins Investment Company, a corporation engaged in the business of negotiating and making loans secured by mortgages and selling such loans to investors, at the time of selling the loans made agreements with the purchasers to pay the purchasers one per cent per annum in addition to the interest rate which the loan carried, the one per cent to be paid during the life of the loan, according to the terms of the bond. These loans extended over a period of years. The question presented is whether the maximum amount for which the Investment Company became obligated upon these agreements was deductible from gross income for the year in which the agreement was made. The appellant claims that it was. The Commissioner ruled that it was not. The court sustained the Commissioner.

THE STATUTE

The pertinent statutory provisions are found in Sections 12(a), 13(a), and 13(d) of the Revenue

Act of 1916, Act of September 8, 1916, c. 463, 39 Stat. 756, 767, 770, 771:

> Sec. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.
>
> Sec. 13. (a) The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December thirty-first:
>
> * * * * *
>
> (d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned * * *.

For the purposes of this case the Revenue Act of October 3, 1917, c. 63, 40 Stat. 300, need not be considered, for it merely changed the rate of the tax.

STATEMENT

From the agreed statement which the court found to be the facts the following appears:

The F. B. Collins Investment Company, hereinafter called the Company, was a corporation of the State of Oklahoma. Its business was that of negotiating and making loans secured by mortgages and the sale of such loans to investors, and it had been engaged in that business since March, 1908. For making loans it received commissions usually in the form of noninterest bearing notes from the borrowers. The amount of the commission on a given loan was fixed at a certain percentum per annum, usually two per cent, of the amount of the loan for its term. The Company's income was derived from these commissions.

Beginning about the year 1916 the Company was able to sell many of its loans direct to investors without the aid or assistance of a broker, though it still sold some through brokers or agents. (R. 8.)

As an inducement to investors to purchase such loans direct, the Company agreed to pay a bonus to the investor upon the sale of such loan, this being an added consideration to the investor for the purchase of the loan, and being made possible by the fact that the Company was relieved from paying

any brokerage fee or agent's commission upon such sale. This bonus or added consideration to the investor was uniformly put in the form of a contract of the Company by which it became obligated and bound to pay to such investor one per cent of the principal of the loan annually during the life thereof. (R. 8.)

As an illustration of the nature of the Company's business and the method by which each transaction was handled, the following was submitted (R. 9):

A borrower made application to the Company for a five-year farm mortgage loan for the sum of $10,000, and executed his principal note or bond to the Company bearing interest at the rate of five per cent per annum payable annually.

At the same time the borrower executed another note for the sum of $1,000, which was noninterest bearing until maturity, and which was usually due in two years from date, and which represented the Company's commission for services in making the loan. The principal note was secured by a first mortgage, and the commission note was usually secured by a second mortgage upon the same real estate. (R. 9.)

In order to sell the $10,000 principal note direct to an investor, and as an inducement to him to purchase, the Company agreed to pay such investor an amount equal to one per cent per annum on the principal of the note, payable annually, for the full term thereof, or until payment, if paid before

maturity. The Company's obligation to pay this one per cent per annum was by a written contract evidenced as follows (R. 9, 11):

> Special Guarantee. Loan No. 2000
>
> Whereas, the F. B. Collins Investment Company (a corporation) is the mortgagee in a certain mortgage for Thousand and no/100 Dollars, executed by John Doe and Mary Doe, his wife, dated the 30th day of June, 1918, covering certain immovable property situate in Lincoln County, State of Oklahoma.
>
> Whereas, Said loan has been sold to Eastern Investor and in consideration of the purchase thereof, the said The F. B. Collins Investment Company hereby agrees to pay the said purchaser One per cent per annum in addition to the Five per cent the loan bears. The said One per cent to be paid during the life of said loan, according to the terms contained in the bond.
>
> Dated at Oklahoma City, Oklahoma, this 1st day of July, 1918.
>
> The F. B. Collins Investment Company, by (Signed) ----------,
> Vice President.
>
> Attest: (Signed) ----------,
> Secretary.

At the time the note was sold to the investor, the Company charged on its books, as an expense incurred in the sale of the loan, the full amount of the annual payments provided for in this so-called

bonus contract computed at one per cent per annum on the face of the loan from the date of the contract to the maturity of the loan, and credited the investor on its books with a like amount. (R. 9.)

The credits to investors' accounts by reason of these bonus contracts were handled on a subsidiary bills payable ledger, and the total amount of this liability of the Company, as shown by this ledger, was carried on the general ledger under a control account called the Guaranty Fund Account. (R. 9.) The form of bond or note taken by the Company in making its loans to borrowers, a copy of which is attached to the agreed statement of facts as Exhibit B (R. 12), provided for the payment of $100, or a multiple thereof, or the whole amount of the loan at "the maturity of any interest payment," on and after two years, at the option of the borrower, by giving sixty days' notice. In a few instances the privilege of paying the note before maturity was allowed at the end of one year. Quite frequently it was fixed at three years or after, but the usual time was at or after two years. (R. 9.)

Should the principal loan be paid before maturity, the difference between the amount of the bonus contract credited to the investor's account at the time the loan was sold to him, and the actual payments made on such bonus contract by the Company, was credited back to profit and loss and treated as income of the Company for the year in which the payment of the principal loan occurred. (R. 9.)

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The Company consistently kept its books of account from year to year on an accrual basis. For the year 1917, it accrued and set up on its books as a liability, and charged to expense, the total amount of the annual payments provided for in bonus contracts executed and issued during that year, the amount of each contract being taken at one per cent per annum of the amount of the loan to which it related from the date of the contract to the maturity date of the loan. This practice had been followed from the inception of the Company's so-called bonus method of selling its securities. Its tax return for the year 1917 was made upon the basis upon which its accounts were kept. (R. 10.) During the year 1917, the Company executed its bonus contracts in the aggregate amount of $11,082.90. In arriving at this aggregate sum, the amount of each contract was fixed at one per centum of the amount of the loan to which it related computed from the date of the contract to the maturity of the loan. The Company claimed this sum of $11,082.90 was an expense incurred and accrued in its business and as such deductible from income The Commissioner disallowed the deduction of this sum, but allowed as a deduction only the amount representing the company's obligations under its agreements which matured within the year 1917, and which amount was the sum of $1,677.11, the difference being $9,405.79. The right of the Company to the deduction of this latter sum is the question in dispute in this action, and the

tax involved is attributed solely to this item. If it was not deductible, then the Company's tax was correctly assessed. If it was deductible, then the plaintiff was entitled to recover $4,287.64 plus $463.12, interest paid thereon, or a total of $4,750.76, with interest on such total from December 30, 1922. (R. 10.)

SUMMARY OF ARGUMENT

The appellant contends that the total amount of the obligations of the Company, evidenced by its bonus contracts, was an ordinary business expense incurred in the year in which the contracts were issued; that since the Company kept its books and made its return on an accrual basis, the total of the bonus contracts issued during the year at their full face value or amount was deductible from gross income; and that its method of keeping its books and making its return correctly reflected the Company's income.

The United States contends that the Company's method of keeping its books and making its return did not correctly reflect its income; that to charge as an item of expense, in any one year, the total amount of a liability under an agreement payable over a period of years, was not an accrual method, but merely an anticipation of future unaccrued expenses which, as a matter of fact, might never accrue, and the amount of which was, in any case, uncertain. Only such items of expense under the bonus contracts as were paid or accrued during the

taxable year were properly deductible from the income of that year.

ARGUMENT

THE DEDUCTIONS CLAIMED DID NOT ACCRUE WITHIN THE TAX YEAR, NOR DID THE METHOD USED BY THE COMPANY CLEARLY REFLECT ITS TRUE INCOME.

(a) *The deductions claimed did not accrue within the tax year.*

The appellant's claim misconceives and misuses the term accrue. Under the Acts prior to the Act of 1916, corporations were not permitted to deduct expenses except as paid, and Section 13 (d) of the Revenue Act of 1916 represented a departure in that respect. See *United States* v. *Anderson*, 269 U. S. 422. After the passage of the Act and on January 8, 1917, Treasury Decision 2433, set forth on pages 27 and 28 of appellant's brief, was issued. Under the statute and this decision the accrual system was authorized as a basis for return and taxation. So corporations keeping their books upon an accrual basis were authorized to deduct expenses accrued, subject to regulations and upon the condition that the basis which they adopted clearly reflected income.

The method used by the Company was not in accordance with the accrual principle of accounting. According to the definitions adopted by the American Association of Public Accountants, accrual means "that portion of an accruing account not yet due applicable to the accounts of the

period under consideration." To accrue means "to set up or record a debit or credit automatically accumulating through lapse of time." (See Year Book 1915, American Association of Public Accountants, p. 67, adopting report (p. 160) of its Committee on Accounting Terminology.) The only portion of the liability of the Company under its bonus contracts applicable to the period under consideration was that which accumulated during the year 1917. In principle it was no different from what it would have been had the Company sold at par a United States bond maturing in five years and redeemable in two years, with an agreement to pay the purchaser, until the bond should be paid or redeemed, an additional one per cent interest. If the Company had bought the bond at par, there would have been no profit or loss on the transaction. The agreement to pay the additional one per cent would not have affected the profit or loss, or income of that year except as it "accrued."

The appellant argues that these agreements represented an expense of the business, which may be conceded. It also argues that the contractual obligation was "incurred" at the time the contract was made. But incurred is by no means the same thing as "accrued." The typical bond (Exhibit B, R. 12) was payable five years after date with interest payable semi-annually. When the obligor signed that bond he incurred the obligation, but his obligation to pay the interest only "accrued" as the interest accumulated and became payable

through the lapse of time. So with the obligation of the Company to pay the additional one per cent. It "accrued" in the same manner, at the same time, and for the same reason as did the interest payments upon the loan. Compare *Edwards* v. *Keith,* 231 Fed. 110; *Woods* v. *Lewellyn,* 252 Fed. 106.

Under the statute each year's income stands by itself and must be measured on the basis of an annual closing of the books. During the tax year in question the Company sold certain mortgages maturing at varying periods thereafter and containing provisions giving the debtor the right to pay off the mortgage in whole or in part before the date of maturity. At the same time the Company entered into executory contracts with the purchasers whereby it agreed to pay to the purchaser one per cent per annum in addition to the rate the loans bore, the one per cent to be paid during the life of the loan according to the terms contained in the bond. The agreement of the Company, therefore, was to pay one per cent per annum, in addition to the fixed rate of the loan, if, when, and as interest accrued upon the bond. It was payment to the purchaser for the use of his money, to continue while his money was used, to cease when his money was repaid. While perhaps not technically the same as the ordinary agreement to pay interest upon a loan, it was in substance the same, to be measured by the same factors and to become payable at the same time and in the same manner.

The reason for selling the loans was, of course, a desire to obtain money with which to make other loans. "The rapidity of the turnover of its capital in selling its loans and reloaning the money measured the volume of its business and the size of its income." (Appellant's brief, pages 16 and 17.) Selling a loan was a transaction wholly distinct from the original making of it, and involved neither profit nor loss unless the sale was at a premium or a discount. When sold, the Company had, in addition to the commission earned and received when the loan was made, the principal of the loan in cash, which it could devote to any corporate use. To obtain money for present use the Company agreed to pay in the future the equivalent of interest.

(b) *The method used by the Company did not clearly reflect its true income.*

Several times in appellant's brief (pages 15, 65) it is claimed that the notes received as commissions were at once charged to income. This is not shown by the findings, but if true it makes no difference. Receipt of a note is always treated as payment of the account for which it is given. There are no findings upon which to base a claim of inconsistency by the Commissioner in treating income and deductions. That question is not in the case. According to the stipulation and findings (R. 10) the right of the Company to make the deduction "is the question in dispute." If not deductible, "then

the Company's income was correctly fixed by the Commissioner." It may not be assumed that the Commissioner was inconsistent. The burden is upon the taxpayer to establish the invalidity of the tax. *United States* v. *Mitchell,* 271 U. S. 9, 12.

It would appear to be obvious that true income was not reflected by a profit and loss account supposed to be kept upon an accrual basis, upon which was charged, as accrued expenses of the year, the maximum possible amount of items payable after the manner of interest payments, over a period of five years, all of them as yet unearned and some of which might never be earned or paid. According to the finding (R. 9) the Company "credited the investor on its books with a like amount." But that did not give him any right to receive it. He had not yet earned it. He earned it only as his money continued to be used. As he earned it the Company became liable to pay it. It could become income to him and expense to the Company only if, when, and as it was paid or accrued.

The Company carried the total of these accounts on the general ledger under a "control account" called Guaranty Fund Account. Accurate bookkeeping may have required this liability to be shown in some way on the balance sheet, but like other deferred or unaccrued charges or liabilities *ultimately to be carried to profit and loss,* it should be offset on the other side by the amount unaccrued. It is somewhat analogous to the sale by a corporation of its bonds at a discount. The amount of the

discount is set up on the assets side, and from year to year, during the term of the bond, it is charged off as expense. In such a case, however, the amount of the ultimate liability is fixed and the time of payment certain. Here both the amount and duration of the liability are uncertain.

The method adopted by the Company was not an accrual method but merely an anticipation of future expenses. It could not be justified upon the principle of accumulating a reserve for contingent or uncertain liabilities. Reserves are accumulated by accretions year by year to meet a future obligation, not by charging in one year a gross amount payable in installments over a term of years.

If a loan was paid before maturity, the difference between the amount of the bonus contract which the Company had credited to the investor's account at the time the loan was sold, and the actual payments made on such bonus contract, was credited back to profit and loss and treated as income of the Company for the year in which the payment of the principal loan occurred. This was not proper accounting and did not reflect clearly the income of either year. The true income for each year could only be shown by charging to the expense of each year such items as were paid or accrued during that year.

The cases of *United States* v. *Anderson*, and *United States* v. *Yale & Towne Manufacturing*

Company, 269 U. S. 422, extensively quoted in appellant's brief, have no application to the facts of this case nor do they tend to sustain the appellant's contention. They sustain the right of a taxpayer, keeping its books on an accrual basis, to include in its deductions the amount of a reserve entered on its books for taxes imposed by the United States on the profits of munitions made and sold by the taxpayer *during that year*, although the tax was not *payable* until the following year. They contain no intimation that a taxpayer has the right to accrue or create a reserve for taxes of any succeeding year or years, much less to deduct in one year a lump sum for unaccrued expenses uncertain in amount and payable over a series of years.

CONCLUSION

The judgment of the District Court should be affirmed.

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FEBRUARY, 1927.

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